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DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

24 CFR Part 203

[Docket No. FR-5156-F-02]

RIN 2502-AI58

**Federal Housing Administration (FHA) Single Family Lender Insurance Process:
Eligibility, Indemnification, and Termination**

AGENCY: Office of the Assistant Secretary for Housing - Federal Housing Commissioner, HUD.

ACTION: Final rule.

SUMMARY: This final rule updates and enhances the Lender Insurance process, through which the majority of Federal Housing Administration (FHA)-insured mortgages are endorsed for insurance. These changes also further HUD efforts to improve and expand the risk management activities of the FHA. This final rule follows the publication of an October 8, 2010, proposed rule, and takes into consideration public comments received in response to it.

DATES: Effective Date: **[Insert date 30 days from the date of publication in the Federal Register.]**

FOR FURTHER INFORMATION CONTACT: Karin Hill, Director, Office of Single Family Program Development, Office of Housing, Department of Housing and Urban Development, 451 Seventh Street, SW, Room 9278, Washington, DC 20410-8000; telephone number 202-708-4308 (this is not a toll-free number). Persons with hearing or speech impairments may access these numbers through TTY by calling the toll-free Federal Relay Service at 800-877-8339.

SUPPLEMENTARY INFORMATION:

I. Background

On October 8, 2010, at 75 FR 62335, HUD published for public comment a proposed rule to update and enhance the Federal Housing Administration (FHA) Lender Insurance Process. FHA-insured single family mortgages are originated and underwritten through the Direct Endorsement process. A majority of FHA-insured mortgages that are originated and underwritten under the Direct Endorsement process are endorsed for insurance by mortgagees through the Lender Insurance process. Under Direct Endorsement, the mortgagee first determines that the proposed mortgage is eligible for insurance under applicable regulations, and then submits the required documents to FHA for a pre-endorsement review. Direct Endorsement mortgagees that meet the requirements may be approved for Lender Insurance. The Lender Insurance process enables mortgagees approved for the Direct Endorsement process to insure single family mortgages originated and underwritten through the Direct Endorsement process without first submitting documents to FHA. Under the Lender Insurance process, a mortgagee conducts its own pre-insurance review and insures the mortgage without a pre-endorsement review by FHA. In order to be eligible to participate in the FHA single family programs as a Lender Insurance mortgagee, a mortgagee must be an unconditionally approved Direct Endorsement mortgagee that is high performing. The Lender Insurance process is authorized under section 256 of the National Housing Act (12 U.S.C. 1715z-21). The HUD regulations that presently govern the Direct Endorsement and Lender Insurance processes are codified at 24 CFR part 203 (entitled Single Family Mortgage Insurance).

The October 8, 2010, proposed rule furthered HUD efforts to improve and expand the risk management activities of the FHA. The proposed regulatory changes were designed to update and enhances the Lender Insurance process, through which the majority of FHA-insured

mortgages are endorsed for insurance. Most significantly, the proposed rule provided additional guidance on HUD's regulations implementing the statutory requirements regarding mortgagee indemnification to HUD of insurance claims in the case of fraud, misrepresentation, or noncompliance with applicable loan origination requirements. Other proposed regulatory changes addressed the frequency and methodology of HUD's review of mortgagee Lender Insurance performance, and the approval process for Lender Insurance mortgagees that have undergone a corporate restructuring. The Department also took the opportunity afforded by the proposed rule to solicit public comment on whether FHA mortgagees should be required to submit mortgage loan case binders to HUD electronically. Interested readers should refer to the preamble to the October 8, 2010, proposed rule for additional information on the proposed regulatory changes to the Lender Insurance process.

II. This Final Rule; Changes to the October 8, 2010, Proposed Rule

This final rule follows publication of the October 8, 2010, proposed rule and takes into consideration the public comments received on it. The public comment period on the proposed rule closed on December 7, 2010, and HUD received a total of 13 public comments. Comments were submitted by mortgagees, mortgage lending associations, and private citizens. Most of the public comments pertained to the provisions of the proposed rule concerning indemnification.

After careful consideration of the issues raised by the commenters, HUD has decided to adopt an amended version of the proposed rule. Specifically, HUD has made the following changes to the October 8, 2010, proposed rule:

1. Frequency of HUD review. This final rule clarifies that, consistent with reviews of mortgagee performance under the Credit Watch Termination Initiative, HUD will review Lender Insurance mortgagee performance on an ongoing (as opposed to "continual" basis).

2. Scope of termination. The final rule clarifies that the automatic termination of a mortgagee's Lender Insurance authority under § 203.4(d)(3) is limited to actions taken at the institution level of the mortgagee, as opposed to its branches.

3. Knowing standard for indemnification in the case of fraud or misrepresentation. The final rule provides that a mortgagee shall indemnify HUD for an insurance claim if the mortgagee "knew or should have known" that fraud or misrepresentation was involved.

4. Reinstatement process. The final rule provides that mortgagees whose Lender Insurance authority has been terminated may apply for reinstatement in accordance with procedures closely modeled on the existing procedures for a mortgagee seeking reinstatement following termination of its origination approval agreement or Direct Endorsement authority.

As already noted, the October 8, 2010, proposed rule invited public comment on whether FHA mortgagees should be required to submit mortgage loan case binders to HUD electronically. This final rule does not revise the FHA recordkeeping and reporting requirements, but HUD will consider the comments received on this issue on any future rulemaking addressing the electronic submission of case binders.

III. Discussion of Public Comments Received on the October 8, 2010, Proposed Rule

The following section of the preamble presents a summary of the significant issues raised by the public comments in response to the October 8, 2010, proposed rule, and HUD's responses to these issues.

A. Lender indemnification for insurance claims.

Comment: A 5-year indemnification period starting with insurance endorsement is too long for indemnifications demanded for serious and material violations of FHA origination requirements. Several commenters wrote that the proposed 5-year period for indemnification

should be shortened. Commenters wrote that problems occurring more than 2 or 3 years after origination are most commonly due to life events such as loss of employment, divorce, or death, rather than decisions made at origination. The majority of commenters who proposed a shortened time frame suggested a period of 2-to-3 years after insurance endorsement. Commenters wrote that based on their experience, the 2-year time frame would be sufficient to identify serious or material issues occurring in the origination of mortgage loans, to identify defects stemming from the underwriting of mortgage loans, and to determine whether lender error occurred. One commenter wrote that HUD's origination guidelines in Handbook 4155.1 instruct lenders to establish income analysis on continuance for 3 years. The commenter wrote that lenders should not be held culpable beyond HUD's own established credit policy.

HUD Response. HUD has not amended the rule based on these comments.

Indemnification for 5 years from the date of insurance endorsement is the current standard practice for indemnification in connection with other serious mortgagee program violations, and the adoption of a lesser standard for Lender Insurance would be inconsistent with proper risk management practices. HUD continues to believe that the 5-year period is consistent with the twin policy objectives of providing HUD sufficient opportunity to determine whether there was a serious and material noncompliance issue that rendered the loan ineligible for insurance, while at the same time ensuring that mortgagees are not burdened with the possibility of indemnification due to noncompliance for a mortgage loan endorsed more than 5 years ago.

Comment: Indemnification should be limited to those cases where origination deficiencies caused default. Several commenters wrote that HUD should seek indemnification only in circumstances where an origination deficiency directly caused the default. Commenters expressed concern that FHA may seek indemnification due to small or irrelevant deficiencies in

origination if a clear causation standard is not in place. Commenters wrote that a civil money penalty would be a more appropriate penalty than indemnification for loan origination deficiencies not directly related to the mortgage default.

HUD Response. HUD has not amended the rule based on these comments. Current standard practice for indemnification requests is not based on causation connection between the violation and the default, and the adoption of a lesser standard for Lender Insurance would be inconsistent with proper risk management practices. Furthermore, HUD has made it clear that indemnification will be demanded only in cases of serious and material violations of HUD requirements. HUD intends to demand indemnification for loans where fraud, misrepresentation, or serious and material noncompliance are such that the loans were ineligible for insurance. Creating a causation standard (connecting the default to the violation) is unnecessary since FHA should not have incurred the insurance obligation in the first place.

Comment: Proposed bases for indemnification are overly broad. Several commenters wrote that the bases by which HUD may seek indemnification described by the proposed rule are overly broad. The commenters wrote that the proposed bases are subjective and may deter mortgagees from participating in the FHA program or may increase the costs and fees to consumers, because mortgagees absorb the potential for future increased liability. Commenters requested that HUD provide more specific examples illustrating the scenarios under which indemnification may be sought.

HUD Response. HUD has not amended the rule based on these comments. HUD believes that the regulatory language is clear, consistent with current standard practice, and covers the types of violations that are considered serious and material (i.e., ones where the mortgage never should have been endorsed by the lender because FHA would not have insured

the mortgage under the Direct Endorsement process). HUD will issue additional guidance regarding the bases for indemnification should it determine such clarification is necessary.

Comment: An indemnification appeals process is necessary. Several commenters wrote that mortgagees should be provided an opportunity to appeal HUD demands for indemnification. Commenters wrote that mortgagees should be afforded the opportunity to present to HUD information and clarifications that may not have been available at the time for indemnification was issued.

HUD Response. HUD has not amended the rule in response to these comments. HUD notes that the means by which fraud or misrepresentation, or serious and material violations of FHA requirements for purposes of the new regulatory indemnification requirements will be identified in accordance with current standard practice; namely, post endorsement technical reviews, quality assurance monitoring reviews, lender self-reports, Office of Inspector General audits, and investigations, etc. These processes afford mortgagees ample opportunities for meaningful discussion and the submission of additional information.

Comment: HUD should clarify the rule's effect on purchasers and servicers of FHA loans. One commenter requested that HUD provide additional clarification of the term “origination,” by assuring that purchasers or servicers of FHA-insured loans will not be impacted by the proposed indemnification changes. The commenter also requested that HUD make clear the effective date of the indemnification provisions.

HUD Response. Purchasers or servicers of FHA-insured loans will not be impacted by the indemnification changes. As with existing standard practice for indemnification agreements, FHA will pay insurance benefits to the servicer or holder of the mortgage, as long as they are not the same entity that was named in the indemnification agreement. The indemnification

provisions will apply to all demands for indemnification issued on or after the effective date of this final rule.

Comment: Causation and materiality standards for indemnification based on fraud and misrepresentation may be unequal. Several commenters wrote that mortgagees should not be held to a higher standard for fraud or misrepresentation than for serious and material origination violations. These commenters urged HUD to limit the indemnification requirement regarding fraud or misrepresentation to instances where the mortgagee knew, or should have known, of the fraud or misrepresentation. The commenters also suggested that HUD limit the indemnification requirement to those instances involving “material” misrepresentation.

HUD Response: HUD has amended the rule based on this comment, and to conform to HUD’s existing practice regarding indemnification agreements. As with existing standard practice, the final rule reflects that HUD will demand indemnification for cases where the mortgagee knew or should have known of the fraud or misrepresentation.

Comment: FHA mortgage loans receiving an Accept/Approve recommendation from FHA’s TOTAL Scorecard should not be subject to indemnification. Several commenters wrote that loans receiving an Accept/Approve recommendation from FHA’s TOTAL Scorecard should be excluded from the indemnification provisions. These commenters wrote that, in the case of loans approved by this system, the mortgagee is responsible only for data integrity and not for the creditworthiness of the mortgage loan.

HUD Response. HUD has not amended this rule based on this comment. HUD’s current regulations provide that mortgagees are responsible for verifying a borrower’s creditworthiness, irrespective of the results derived from the use of TOTAL. Specifically, CFR 203.254(t) provides that “TOTAL is a tool to assist the mortgagee in managing its workflow and expediting

the endorsement process, and is not a substitute for the mortgagee's reasonable consideration of risk and credit worthiness. Direct Endorsement mortgagees using TOTAL remain solely responsible for the underwriting decision" (emphasis added). The indemnification provisions of this final rule merely emphasize a lender's existing responsibility for verifying a borrower's creditworthiness. In particular, § 203.255(g)(3)(i) of this final rule (adopted without change from the proposed rule) provides that it is a serious and material violation for a lender to fail to verify the creditworthiness, income, and/or employment of the mortgagor in accordance with FHA requirements.

Receiving an Approve/Accept risk recommendation from TOTAL does not absolve mortgagees of their responsibility to consider information beyond that considered by TOTAL, as well as their responsibility for the decisions to approve and close loans or to endorse loans through the Lender Insurance process. Regardless of the risk assessment provided, the mortgagee remains accountable for compliance with FHA regulations, guidelines, and eligibility requirements, as well as for any credit, capacity, and documentation requirements described in the current version of HUD Handbook 4155.1, Mortgage Credit Analysis, and applicable mortgagee letters and other policy directives.

B. Acceptable claim and default rate for Lender Insurance mortgagees.

Comment: Clarify the impact of the methodology of claim and default rate for national lenders and those operating in multiple states. Several commenters requested that HUD address the impact of the revision to the methodology used to determine Lender Insurance eligibility on mortgagees operating on a nationwide basis. Specifically, the commenters requested clarification as to whether the claim and default rate of national mortgagees would be judged solely against those of other national mortgagees and if a nationwide mortgagee's claim and default rate in a particular geographic region or state would be compared to the claim and default

rates of other mortgagees in that region or state. The commenters recommended that a national mortgagee be eligible for Lender Insurance authority if it maintains a claim and default rate at or below 150 percent of the FHA national program average.

Other commenters requested that HUD address how the claim and default rate of a mortgagee operating in more than one state, but not nationwide, will be compared. Commenters requested that HUD describe whether the rate will be compared on a state-by-state basis or using a weighted average. Several commenters suggested that HUD use a state-by-state comparison, which would consider only those states where the mortgagee has originated a meaningful number of loans in the past 2 years in proportion to the mortgagee's total number of originations. Such a process, they wrote, would prevent an unfair denial or loss of Lender Insurance approval based on a small number of loans and defaults originated in one state. Commenters further suggested that HUD eliminate from consideration any state in which the total number of originations made in the past 2 years is equal to, or less than, 5 percent of the mortgagee's total originations.

HUD Response. HUD has not amended the rule based on these comments. To be eligible to participate in the Lender Insurance program, a mortgagee must have a claim and default rate at or below 150 percent of the average rate for all of the states in which it does business. In determining eligibility for Lender Insurance, HUD will compare the percentage of all claims and defaults on loans underwritten by that mortgagee to the percentage of claims and defaults for all loans underwritten in the states in which that mortgagee does business.

Comment: Request for clarification regarding applicable comparison ratios. One commenter requested clarification that the comparison ratio used will be the 2-year default and claim ratio, rather than the one-year ratio. The commenter requested further clarification as to

which ratio, among those available through the Neighborhood Watch system, will be utilized in the comparison.

HUD Response. HUD is using the 2-year period for determining the claim and default compare ratio, which is the standard used for determining ongoing eligibility to participate in FHA programs. As in the current process, HUD will consider those endorsed loans underwritten by the lender with a beginning amortization date within the 2-year period of analysis. Further, HUD will also analyze these loans to determine claims and defaulted loans from the total number of loans underwritten.

Comment: Concerns regarding maintaining acceptable claim and default rates for Lender Insurance mortgagees. Several commenters expressed concern regarding the proposed requirement that mortgagees maintain the initial claim and default rate necessary for Lender Insurance approval to retain eligibility for Lender Insurance. Commenters wrote that the proposed standard fails to recognize the current volatility of the housing market, and could negatively impact mortgagees approved during periods of exceptional economic and industry performance. Commenters requested that HUD consider several different proposals. These commenter suggestions included a proposal that national mortgagees remain eligible for Lender Insurance if they maintain claim and default rates at or below 150 percent of the FHA national program averages. Another proposal would establish default rate goals rather than comparison ratios. Other commenters suggested that HUD establish separate standards based on borrower or loan characteristics that would enable mortgagees to responsibly lend to all segments of the population. One commenter wrote that Lender Insurance status should not be jeopardized by a short period of noncompliance that could result from a statistical anomaly.

HUD Response. HUD has not amended the rule based on these comments. HUD believes that mortgagees should maintain the claim and default rate needed for eligibility and that setting a more lenient standard for retaining Lender Insurance authority is not acceptable from a risk management perspective. HUD also believes that comparing each mortgagee's claim and default rate only to that of those states where it does business will prevent the kind of statistical anomalies of concern to the commenters. Currently, the option to obtain the compare ratio for all states in which a mortgagee does business is available in Neighborhood Watch. Mortgagees are able to compare their claim and default rate for all states in which they do business to the overall claim and default rate for those same states. HUD's Lender Insurance Guide will be updated to provide further clarification and to describe any enhancements to Neighborhood Watch necessary to accomplish this comparison. The Lender Insurance Guide is available for download at http://portal.hud.gov/hudportal/documents/huddoc?id=DOC_12648.pdf.

Comment: Requested clarification of "continual" HUD review of acceptable claim and default rates. Several commenters wrote that HUD's proposed "continual" review standard is vague due to the failure to describe the time period of review. One commenter noted that data is refreshed on a monthly basis, and asked if this implies that HUD would evaluate mortgagee claim and default rates on a monthly basis. Commenters also wrote that the proposed standard does not provide mortgagees with the opportunity to make self-imposed corrections to rectify problems identified by their own monitoring systems, or provide them with a cure period to correct deficiencies identified by HUD. Some commenters recommended that FHA maintain its current policy of yearly review. Many commenters requested that HUD define "continual" to

enable mortgagees to plan appropriately for any resulting additional costs and staffing requirements.

HUD Response. HUD has not revised the substance of this provision in response to the comments. HUD reserves the right to monitor the performance of Lender Insurance mortgagees on a continual basis. HUD must be able to respond quickly to poor mortgagee performance in order to fulfill its statutory obligation to safeguard the FHA mortgage insurance funds. Moreover, such ongoing review is consistent with the wording of the Department's regulations for the monitoring of mortgagee performance under the FHA Credit Watch Termination Initiative (see 24 CFR 202.3(c)(2), which states that HUD will review the performance of mortgagees "on an ongoing basis"). That said, this final rule makes one minor change to the wording of this provision for the sake of consistency with the Credit Watch Termination Initiative. It adopts the language used in § 202.3(c) by referring to monitoring on an "ongoing basis."

C. Other proposed rule changes.

Comment: Concerns regarding termination of Lender Insurance authority. Several commenters expressed concern about the proposed regulatory changes pertaining to the termination of Lender Insurance authority. The commenters requested that HUD provide specific grounds that would trigger termination, and clarify that FHA will repeal a mortgagee's Lender Insurance authority only for material adverse actions. The commenters requested that HUD remove the word "any" when describing the specific grounds for terminations. Commenters wrote that use of the word "any" could imply that a lender's authority could be terminated for a minor or trivial action. Commenters also suggested that mortgagees be provided an opportunity for an informal conference prior to issuance of a termination notice. Commenters

further wrote that mortgagees be provided a cure period for offenses that could jeopardize a mortgagee's Lender Insurance authority.

HUD Response. HUD agrees with the commenters that examples and guidance can be particularly helpful in regard to the policies and procedures affecting the termination and reinstatement of Lender Insurance authority. To that end, HUD has issued its Lender Insurance Guide to assist lenders, HUD staff, and contractors who participate in the pre-insurance review, post endorsement technical review, and appraisal review processes. The Lender Insurance Guide, which is available for download at http://portal.hud.gov/hudportal/documents/huddoc?id=DOC_12648.pdf, also provides examples of actions that will trigger termination.

Moreover, and as noted above in this preamble, this final rule brings additional clarity to the Lender Insurance process by codifying a process for the reinstatement of mortgagees who have had their Lender Insurance process terminated. The reinstatement procedures are closely modeled on the existing reinstatement process for a mortgagee seeking reinstatement following termination of its origination approval agreement or Direct Endorsement authority codified at 24 CFR 202.3(e). The use of the existing process has the benefit of already being familiar to lenders and HUD staff, and obviates the need for meeting new paperwork and other regulatory requirements.

Consistent with the current reinstatement process at 24 CFR 202.3(e)(1)(i), this final rule provides that a mortgagee whose Lender Insurance authority is terminated must wait at least 6 months following termination to apply for reinstatement. In addition to addressing the criteria for Lender Insurance approval specified in § 203.4, the application for reinstatement must be accompanied by a corrective action plan addressing the issues resulting in the termination of the

mortgagee's Lender Insurance authority, along with evidence that the mortgagee has implemented the corrective action plan. The requirement for a corrective action plan tracks the similar requirement for reinstatement of Direct Endorsement and origination approval at 24 CFR 202.3(e)(2)(iii). HUD may grant the mortgagee's application for reinstatement if the mortgagee's application is complete and HUD determines that the underlying causes for the termination have been satisfactorily remedied. Mortgagees are reminded that the Lender Insurance Program is a process for endorsing loans for insurance only. Termination of this authority does not impact a mortgagee's ability to seek insurance for a loan originated in accordance with FHA guidelines.

Comment: Procedures governing Lender Insurance approval in instances of merger, acquisition, or restructuring. Commenters welcomed the proposed provisions regarding merged, acquired, or restructured mortgagees. Several commenters also requested that HUD reconsider regulatory waivers as a means to address situations where a newly reorganized corporate entity may merit Lender Insurance approval but not meet the proposed regulatory standards.

HUD Response. HUD appreciates the support of commenters on this issue. HUD notes that the phrase "merger, acquisition, or reorganization" would include changes among parent companies and their subsidiaries. As noted in the preamble to the proposed rule, HUD's goal in crafting the regulatory language is to limit the need for regulatory waivers.

D. Mandatory electronic submission of case binders.

Comment: Use of mandatory electronic submission of case binders. Several commenters supported the electronic submission of case binders, writing that the proposed requirement will make the FHA insurance process more efficient. Commenters, however, wrote that electronic submission of case files should include only those files selected for technical review at HUD's

request rather than for all files related to FHA-insured loans. The commenters wrote that requiring submission of all loan files would be costly and would provide FHA with more information than it could substantively review. Some of the commenters were particularly concerned about the impact on smaller mortgage banks and correspondents. These commenters wrote that HUD should consider the readiness of the industry to implement the requirement prior to setting a specific implementation date.

HUD Response. While HUD appreciates the comments received on this issue, this final rule does not revise the FHA recordkeeping and submission requirements. HUD is further considering the issue of electronic submission of case binders, including the concerns expressed by the commenters. As noted earlier, these comments will be addressed in any future rulemaking regarding electronic case binder submission.

IV. Findings and Certifications

Regulatory Planning and Review

The Office of Management and Budget (OMB) reviewed this rule under Executive Order 12866 (entitled “Regulatory Planning and Review”). OMB determined that this rule is a "significant regulatory action," as defined in section 3(f) of the Order (although not an economically significant regulatory action, as provided under section 3(f)(1) of the Order).

This final rule modifies 3 existing areas affecting FHA-approved lenders. First, this rule imposes indemnification provisions on all approved mortgagees with Lender Insurance authority. Second, this rule amends the methodology and requirements for determining an acceptable claim and default rate. Lastly, this final rule amends the 2-year historical performance requirement for mortgagees resulting from merger, acquisition, or reorganization. Other provisions of this rule describe clarifying or technical changes that would not produce an economic impact. HUD’s

analysis indicates that these regulatory amendments will not have an economic effect of greater than \$100 million and thus do not require a regulatory impact analysis. The findings of HUD's analysis are summarized below:

1. Indemnification requirements. With regard to indemnification, this final rule codifies much of the existing practice and should not result in a dramatic change in underwriting practices and the quality of FHA loans, assuming that all of FHA's direct endorsement lenders currently conduct due diligence in extending FHA-insured loans. There will be a marginal change for those lenders with ineffective risk management practices and those lenders that have refused to execute an indemnification agreement; such lenders may elect instead to attempt to negotiate a settlement with HUD's Mortgage Review Board.

The primary change is that all direct endorsement lenders with lender insurance authority will be subject to indemnification procedures and will not be able to negotiate the settlement as is the current practice. This facet of the rule could lead to an efficiency: the initial process by a lender of deciding whether to indemnify FHA will be eliminated, along with eliminating the length and cost of negotiations. Time and effort may be saved because the costs of a lengthy preparation for both FHA and the lender in coming before the Mortgage Review Board are reduced by this final rule. On the other hand, the elimination of the lender's option to challenge the indemnification before the Mortgage Review Board could lead to greater expenses for those cases that would have been dismissed under the current practice.

The average over the last 7 years is 1,282 indemnification agreements annually. Refusals to execute an indemnification agreement are rare. If the average negotiation costs are 2 percent of loan amount for both FHA and lender (approximately \$140,000 is the average FHA-insured mortgage amount), then the transaction costs to avoid or delay the indemnification would be

\$2,800 per loan. Over an average of 1,300 indemnifications, and assuming that 5 percent initially refuse to indemnify, the aggregate transaction costs saved by this rule would be \$182,000.

2. Acceptable Claim and Default Rate. The final rule makes two changes regarding acceptable claim and default rates for Lender Insurance mortgagees. First, the rule more accurately evaluate a mortgagee's performance record by basing the claim and default-rate comparison on the mortgagee's actual area of operations. The rule also clarifies that, in order to retain their Lender Insurance authority, mortgagees must maintain the acceptable claim and default rate required of them when they were initially delegated such authority.

These regulatory changes will accurately evaluate a mortgagee's performance record by basing the claim and default rate comparison on the mortgagee's actual area of operations. This will likely lead to an increase in opportunity for some lenders but may lead to a decrease for others. It is difficult to know what the net effect of these regulatory changes on lenders will be. Some will be excluded and others will be included, depending upon where they operate. To simulate the regulatory changes, we turn to data on active direct endorsement lenders.

Using active Direct Endorsement lenders as a base, 18 are included through this provision. The change in the performance analysis requirement (maintaining an acceptable default and claim rate) appears to reduce the number of direct endorsement lenders that meet the requirement (113 active direct endorsement lenders). The combined effect of the two changes in eligibility is to exclude direct endorsement lenders currently participating in lender insurance (a reduction of 54).

In the short run, this effect can be thought of as a transfer between lenders of different regions. In the long run, HUD expects the impact of this rule to be geographically neutral.

Lenders will not be permanently reduced as a result of this rule; rather, HUD expects that lenders that can meet the eligibility criteria will eventually assume the business of those that could not meet the new eligibility criteria. The benefits of a clearer and fairer methodology are expected to endure.

3. Lender Insurance Approval in the Case of Corporate Restructuring. The proposed rule would facilitate the compliance of new lending institutions resulting from a merger, acquisition, or reorganization with the statutory requirements for Lender Insurance approval. The proposed rule would thus make changes designed to provide additional regulatory flexibility and better reflect existing market conditions. The regulatory 2-year performance history requirement may impose a burden on lenders whose compliance with FHA requirements was not affected by the business reorganization. Although HUD has in the past granted regulatory waivers to address this problem, the proposed rule will codify a solution that is less administratively burdensome than the regulatory waiver process.

The full economic analysis is available for review at www.regulations.gov. The docket file for this rule is available for public inspection in the Regulations Division, Office of General Counsel, Department of Housing and Urban Development, 451 7th Street, SW, Room 10276, Washington, DC 20410-0500. Due to security measures at the HUD Headquarters building, please schedule an appointment to review the docket file by calling the Regulations Division at 202-402-3055 (this is not a toll-free number). Individuals with speech or hearing impairments may access this number via TTY by calling the toll-free Federal Relay Service at 800-877-8339.

Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) (5 U.S.C. 601 et seq.) generally requires an agency to conduct a regulatory flexibility analysis of any rule subject to notice and comment rulemaking

requirements, unless the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities.

As more fully discussed in the “Regulatory Flexibility Act” section of the preamble to the October 8, 2010, proposed rule, the amendments made by this final rule do not add any new regulatory burdens on FHA-approved mortgagees. Rather, the final rule codifies much of existing practice regarding indemnification. HUD is also revising the methodology for determining acceptable claim and default rates, and making several other changes designed to provide additional flexibility and to better reflect changing market conditions. These changes will have an overall beneficial economic impact on small business mortgagees. To the extent that the changes have any negative impact, it will be as a consequence of the mortgagee’s inability to maintain acceptable risk management practices, and not as a result of a HUD regulatory mandate. Interested readers are referred to the analysis provided in the “Regulatory Flexibility Act” section of the preamble to the proposed rule, commencing at 75 FR 62340.

For the above reasons, the undersigned certifies that this rule will not have a significant economic impact on a substantial number of small entities.

Environmental Impact

A Finding of No Significant Impact (FONSI) with respect to the environment was made at the proposed rule stage, in accordance with HUD regulations at 24 CFR part 50, which implement section 102(2)(C) of the National Environmental Policy Act of 1969 (42 U.S.C. 4332(2)(C)). The Finding of No Significant Impact remains applicable to this final rule and is available for public inspection between the hours of 8 a.m. and 5 p.m. weekdays in the Regulations Division, Office of General Counsel, Department of Housing and Urban Development, 451 Seventh Street, SW, Room 10276, Washington, DC 20410. Due to security

measures at the HUD Headquarters building, please schedule an appointment to review the FONSI by calling the Regulations Division at 202-708-3055 (this is not a toll-free number). Individuals with speech or hearing impairments may access this number via TTY by calling the Federal Relay Service at 800-877-8339.

Executive Order 13132, Federalism

Executive Order 13132 (entitled "Federalism") prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial direct compliance costs on state and local governments and is not required by statute, or the rule preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This rule will not have federalism implications and would not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

Unfunded Mandates Reform Act

Title II of the Unfunded Mandates Reform Act of 1995 (2 U.S.C. 1531-1538) (UMRA) establishes requirements for federal agencies to assess the effects of their regulatory actions on state, local, and tribal governments, and on the private sector. This final rule does not impose any federal mandates on any state, local, or tribal governments, or on the private sector, within the meaning of UMRA.

Paperwork Reduction Act

The information collection requirements for this final rule have been approved by the Office of Management and Budget (OMB) under the Paperwork Reduction Act of 1995 (44 U.S.C. 3501-3520) and assigned OMB control number 2502-0059. In accordance with the Paperwork Reduction Act, an agency may not conduct or sponsor, and a person is not required to

respond to, a collection of information, unless the collection displays a currently valid OMB control number.

Catalogue of Federal Domestic Assistance

The Catalogue of Federal Domestic Assistance Number for the principal FHA single family mortgage insurance program is 14.117.

List of Subjects in 24 CFR Part 203

Hawaiian Natives, Home improvement, Indians-lands, Loan programs – housing and community development, Mortgage insurance, Reporting and recordkeeping requirements, Solar energy.

Accordingly, for the reasons discussed in the preamble, HUD amends 24 CFR part 203 to read as follows:

PART 203 – SINGLE FAMILY MORTGAGE INSURANCE

1. Revise the authority citation for part 203 to read as follows:

Authority: 12 U.S.C. 1709, 1710, 1715b, 1715z-16, 1715u, and 1717z-21; 42 U.S.C. 3535(d).

2. In § 203.4, revise the reference in paragraph (a) to “§ 203.5” to read “§ 203.3”, revise paragraphs (b), (c), and (d), and add paragraph (e) to read as follows:

§ 203.4 Approval of mortgagees for Lender Insurance.

* * * * *

(b) Performance: Claim and default rate. (1) In addition to being unconditionally approved for the Direct Endorsement program, a mortgagee must have had an acceptable claim and default rate (as described in paragraph (b)(3) of this section) for at least 2 years prior to its

application for participation in the Lender Insurance program, and must maintain such a claim and default rate in order to retain Lender Insurance approval.

(2) HUD may approve a mortgagee that is otherwise eligible for Lender Insurance approval, but has an acceptable claim and default record of less than 2 years, if:

(i) The mortgagee is an entity created by a merger, acquisition, or reorganization completed less than 2 years prior to the date of the mortgagee's application for Lender Insurance approval;

(ii) One or more of the entities participating in the merger, acquisition, or reorganization had Lender Insurance approval at the time of the merger, acquisition, or reorganization;

(iii) All of the lending institutions participating in the merger, acquisition, or reorganization that had Lender Insurance approval at the time of the merger, acquisition, or reorganization had an acceptable claim and default record for the 2 years preceding the mortgagee's application for Lender Insurance approval; and

(iv) The claim and default record of the mortgagee derived by aggregating the claims and defaults of the entities participating in the merger, acquisition, or reorganization, for the 2-year period prior to the mortgagee's application for Lender Insurance approval, constitutes an acceptable rate of claims and defaults, as defined by this section.

(3) A mortgagee has an acceptable claim and default rate if its rate of claims and defaults is at or below 150 percent of the average rate for insured mortgages in the state(s) in which the mortgagee operates.

(c) Reviews. HUD will monitor a mortgagee's eligibility to participate in the Lender Insurance program on an ongoing basis.

(d) Termination of approval. (1) HUD may immediately terminate the mortgagee's approval to participate in the Lender Insurance program, in accordance with section 256(d) of the National Housing Act (12 U.S.C. 1715z-21(d)), if the mortgagee:

(i) Violates any of the requirements and procedures established by the Secretary for mortgagees approved to participate in HUD's Lender Insurance program, Direct Endorsement program, or the Title II Single Family mortgage insurance program; or

(ii) If HUD determines that other good cause exists.

(2) Such termination will be effective upon receipt of HUD's notice advising of the termination. Within 30 days after receiving HUD's notice of termination, a mortgagee may request an informal conference with the Deputy Assistant Secretary for Single Family Housing or designee. The conference will be conducted within 30 days after HUD receives a timely request for the conference. After the conference, the Deputy Assistant Secretary (or designee) may decide to affirm the termination action or to reinstate the mortgagee's Lender Insurance program approval. The decision will be communicated to the mortgagee in writing, will be deemed a final agency action, and, pursuant to section 256(d) of the National Housing Act (12 U.S.C. 1715z-21(d)), is not subject to judicial review.

(3) Lender Insurance authority is automatically terminated for a mortgagee whose nationwide Direct Endorsement approval under § 203.3(d)(2) is terminated, without imposing any further requirement on the mortgagee to comply with this paragraph.

(4) Any termination instituted under this section is distinct from withdrawal of mortgagee approval by the Mortgagee Review Board under 24 CFR part 25.

(e) Reinstatement. A mortgagee whose Lender Insurance authority is terminated under this section may apply for reinstatement if the Lender Insurance authority for the mortgagee has

been terminated for at least 6 months. In addition to addressing the criteria for Lender Insurance approval specified in paragraphs (a) and (b) of this section, the application for reinstatement must be accompanied by a corrective action plan addressing the issues resulting in the termination of the mortgagee's Lender Insurance authority, along with evidence that the mortgagee has implemented the corrective action plan. HUD may grant the mortgagee's application for reinstatement if the mortgagee's application is complete and HUD determines that the underlying causes for the termination have been satisfactorily remedied.

3. In § 203.255, revise paragraph (f)(1), remove paragraph (f)(4), and add paragraph (g) to read as follows:

§ 203.255 Insurance of mortgage.

* * * * *

(f) Lender Insurance. (1) Pre-insurance review. For applications for insurance involving mortgages originated under the Lender Insurance program under § 203.6, the mortgagee is responsible for performing a pre-insurance review that would otherwise be performed by HUD under § 203.255(c) on the documents that would otherwise be submitted to HUD under § 203.255(b). The mortgagee's staff that performs the pre-insurance review must not be the same staff that originated the mortgage or underwrote the mortgage for insurance.

* * * * *

(g) Indemnification. (1) General. By insuring the mortgage, a Lender Insurance mortgagee agrees to indemnify HUD, in accordance with this paragraph.

(2) Definition of origination. For purposes of indemnification under this paragraph, the term "origination" means the process of creating a mortgage, starting with the taking of the

initial application, continuing with the processing and underwriting, and ending with the mortgagee endorsing the mortgage note for FHA insurance.

(3) Serious and material violation. The mortgagee shall indemnify HUD for an FHA insurance claim paid within 5 years of mortgage insurance endorsement, if the mortgagee knew or should have known of a serious and material violation of FHA origination requirements, such that the mortgage loan should not have been approved and endorsed by the mortgagee and irrespective of whether the violation caused the mortgage default. Such a serious and material violation of FHA requirements in the origination of the mortgage may occur if the mortgagee failed to, among other actions:

(i) Verify the creditworthiness, income, and/or employment of the mortgagor in accordance with FHA requirements;

(ii) Verify the assets brought by the mortgagor for payment of the required down payment and/or closing costs in accordance with FHA requirements; or

(iii) Address property deficiencies identified in the appraisal affecting the health and safety of the occupants or the structural integrity of the property in accordance with FHA requirements, or

(iv) Ensure that the appraisal of the property serving as security for the mortgage loan satisfies FHA appraisal requirements, in accordance with § 203.5(e).

(4) Fraud or misrepresentation. The mortgagee shall indemnify HUD for an insurance claim if the mortgagee knew or should have known that fraud or misrepresentation was involved in connection with the origination of the mortgage, regardless of whether the fraud or misrepresentation caused the mortgage default and regardless of when an insurance claim is filed.

(5) Demand for indemnification. The demand for indemnification will be made by either the Secretary or the Mortgagee Review Board. Under indemnification, the Lender Insurance mortgagee agrees to either abstain from filing an insurance claim, or reimburse FHA if a subsequent holder of the mortgage files an insurance claim and FHA suffers a financial loss.

Date: January 18, 2012

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